Advice Attention Experience

Dickinson Graham Capital Management

Dickinson Graham Capital Management
42053 10th Street West
Lancaster, CA 93534
661-471-2403
info@DickinsonGraham.com
DickinsonGraham.com

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Quiz: Test Your Interest Rate Knowledge

In December 2015, the Federal Reserve raised the federal funds target rate to a range of 0.25% to 0.50%, the first rate increase from the near-zero range where it had lingered for seven years. Many economists viewed this action as a positive sign that the Fed had finally deemed the U.S. economy healthy enough to withstand slightly higher interest rates. It remains to be seen how rate increases will play out for the remainder of 2016. In the meantime, try taking this short quiz to test your interest rate knowledge.

Quiz

1. Bond prices tend to rise when interest rates rise.

a. True

b. False

2. Which of the following interest rates is directly controlled by the Federal Reserve Open Market Committee?

a. Prime rate

b. Mortgage rates

c. Federal funds rate

d. All of the above

e. None of the above

3. The Federal Reserve typically raises interest rates to control inflation and lowers rates to help accelerate economic growth.

a. True

b. False

4. Rising interest rates could result in lower yields for investors who have money in cash alternatives.

a. True

b. False

5. Stock market investors tend to look unfavorably on increases in interest rates.

a. True

b. False

Answers

1. b. False. Bond prices tend to *fall* when interest rates rise. However, longer-term bonds may feel a greater impact than those with shorter maturities. That's because when interest rates are rising, bond investors may be reluctant to tie up their money for longer periods if they anticipate higher yields in the future; and the longer a bond's term, the greater the risk that its yield may eventually be superceded by that of newer bonds. (The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost.)

2. c. Federal funds rate. This is the interest rate at which banks lend funds to each other (typically overnight) within the Federal Reserve System. Though the federal funds rate affects other interest rates, the Fed does not have direct control of consumer interest rates such as mortgage rates.

3. a. True. Raising rates theoretically slows economic activity. As a result, the Federal Reserve has historically raised interest rates to help dampen inflation. Conversely, the Federal Reserve has lowered interest rates to help stimulate a sluggish economy.

4. b. False. Rising interest rates could actually benefit investors who have money in cash alternatives. Savings accounts, CDs, and money market vehicles are all likely to provide somewhat higher income when interest rates increase. The downside, though, is that if higher interest rates are accompanied by inflation, cash alternatives may not be able to keep pace with rising prices.

5. a. True. Higher borrowing costs can reduce corporate profits and reduce the amount of income that consumers have available for spending. However, even with higher rates, an improving economy can be good for investors over the long term.

A portion of the permanent life insurance premium goes into a cash value account, which accumulates on a tax-deferred basis throughout the life of the policy. Withdrawals of the accumulated cash value, up to the amount of the premiums paid, are not subject to income tax. Loans are also free of income tax as long as they are repaid. Loans and withdrawals from a permanent life insurance policy will reduce the policy's cash value and death benefit. Any guarantees are contingent on the claims-paying ability and financial strength of the issuing insurance company.

There are expenses associated with the purchase of life insurance, including mortality and expense charges. If a policy is surrendered prematurely, there may also be surrender charges and income tax implications. The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. Before implementing a strategy involving life insurance, it would be prudent to make sure that you are insurable.

Retain and Reward Key Employees with an Executive Bonus Plan

The success of a business, especially a small business, is often predicated on the performance and retention of a few key employees. The financial impact and stress resulting from the departure of an important employee can be significant. One way business owners can try to retain and reward their key employees is by offering extra compensation in the form of a nonqualified executive bonus (IRC Section 162) plan. These types of plans often use permanent life insurance as the funding vehicle.

What is it?

An executive bonus arrangement is an addition to regular salary or compensation that business owners can provide to key employees or executives of their choice. The bonus may be used by the employee to purchase permanent life insurance.

There are no legal requirements for anything to be filed with the government or for the plan to be in writing. However, a written plan is often desirable because it can outline the conditions that must be met in order for the employee to qualify for the bonus, and it can state the obligations of the business to pay the bonus.

How does it work?

The business provides extra compensation to the key employee in the form of a bonus. If life insurance is used as the funding vehicle, the employer may make the bonus payment directly to the insurance company, or the employee can make the premium payments.

In some instances, the employer will pay a "double bonus" to the employee to pay for any income taxes owed by the employee that are attributable to the bonus. To cover premium payments and to maintain the tax advantages of cash accumulation for the employee, the employer should plan on making ongoing bonus payments instead of a one-time bonus so the policy isn't classified as a modified endowment contract.

The employee is the insured and owner of the life insurance policy and may name the policy beneficiaries. The life insurance policy may accumulate cash value, which can be accessed by the employee during his or her lifetime. Generally, any cash accumulation within the policy will grow tax deferred. Policy death benefits are paid to the employee's beneficiaries named in the policy.

What are the tax considerations?

Bonuses are generally deductible by an employer according to the same rules as other forms of cash compensation. A bonus cannot be deducted unless it constitutes a reasonable allowance for services actually rendered.

A bonus is taxed to the employee as ordinary taxable income. Because employees generally file taxes according to the cash method (rather than the accrual method), the bonus is taxable to the employee when it is received.

Considerations for the employer

- Extra compensation in the form of a bonus can attract, motivate, and retain key employees.
- The plan is generally simple to implement and easy to administer, with no formalities or funding requirements.
- The employer has complete discretion in selecting which employees to reward.
- The employer may be able to deduct the bonus as a reasonable business expense.
- The employer can set terms and conditions that must be met by the employee to qualify for the bonus.

Considerations for the employee

- The employee receives life insurance protection for his or her family at little or no cost (assuming the employer also covers the tax obligation of the employee attributable to the bonus).
- The employee owns the policy and names the policy beneficiaries.
- Permanent life insurance may accumulate tax-deferred cash value over time, which the employee can access to supplement retirement or to meet other needs or expenses.
- The bonus may be contingent on continued employment or performance goals.
- The employee must be insurable in order for life insurance to work as the plan funding vehicle.

A way to retain and reward employees

A principal challenge to employers is figuring out how to retain and reward key employees. These goals can be promoted by providing executive bonuses to key employees, who can use the bonuses to fund a life insurance policy. Life insurance may be a useful funding vehicle because it can provide a tax-free benefit to the employee's chosen beneficiaries and it may accumulate tax-deferred cash value.

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Clusters, Crowdfunding, and Other Ways Small Businesses Survive

Small-business owners must rely on their own ingenuity and innovation to survive. Fortunately, over the past decade, innovation has also emerged in the networks supporting small businesses, helping them acquire much-needed resources.

Clusters: strength in numbers

Clusters are groups of businesses, suppliers, academic institutions, and other related organizations working within the same industry and concentrated in the same geographic region. Although they're often competitors, cluster businesses can benefit from access to necessary resources such as talent, raw materials, research, and financing opportunities. Examples of clusters include the medical centers in Massachusetts, the high-tech industry in Silicon Valley, and the wineries in northern California. The advantages gained from organizations working together can include economies of scale and political influence, benefits typically associated with corporate giants such as Walmart and Apple.

In 2010, the Small Business Administration unveiled the Clusters Initiative, a program that invests in 14 regional clusters representing various industries throughout the United States. According to SBA Administrator Maria Contreras-Sweet, the SBA has "built a strategic infrastructure of financing and consulting networks in key cities to help new companies launch and small companies grow."[1] A third-party organization has been tasked with evaluating the SBA program each year. Results from the 2014 report (the most recent data available) include the following:[2]

- A majority of small and large businesses have established at least one alliance with other cluster members.
- Nearly 40% of small businesses said cluster services had some influence on their access to capital.
- Revenues in cluster-associated small businesses increased an average of 6.9%, twice as fast as benchmark firms.
- Average monthly payroll in small businesses grew an annualized 14.1% during the two years ending September 2013, besting benchmarks by almost 11 percentage points.

Crowdfunding: online investing

What started more than a decade ago as a way for art and music lovers to help fund their favorite artists' latest endeavors has evolved into a sophisticated means for small-business owners to raise capital. In the fall of 2015, the Securities and Exchange Commission released final rules governing equity crowdfunding, or the ability for entrepreneurs to issue equity to individual investors over the Internet. Companies can now raise up to $1 million over a 12-month period via "funding portals." Individual investors can invest certain amounts over a 12-month period based on their income and net worth.[3]

Businesses wishing to use this 21st-century financing method will want to be aware of the governing regulations, which include providing certain information to the SEC, potential investors, and the funding portals, including:

- A description of the business and how the funds will be used
- The price of the securities or method of determining the price
- The target offering amount, the fundraising deadline, and whether the company will accept investments exceeding the target
- Financial statements, possibly reviewed by an independent public accountant and accompanied by the company's tax returns

Incubators and accelerators: fueling growth

Incubators and accelerators are organizations that are similar in terms of providing valuable resources and mentorship to new businesses; however, one is intended to help "incubate" the budding business owner's idea, while the other is generally designed to "accelerate" the growth of an existing company.

Business owners apply to these often highly competitive programs and, if accepted, may need to relocate and share space with other similar organizations.

According to the International Business Innovation Association (InBIA), incubators provide companies with programs, services, and space for varying lengths of time based on company needs and incubator policies. By contrast, accelerators take a group of companies through a specific process over a defined period of time, typically three to four months. The program often culminates in a funding pitch or demo day. While accelerators make seed investments in companies in exchange for small equity stakes, incubators typically do not make such investments.

This is just a brief overview of some of the innovative opportunities designed to help small businesses survive. Business owners interested in learning more should start by visiting the websites noted in the sidebar at left.

For more information, visit the following sites:

Clusters: sba.gov

Crowdfunding: sec.gov

Incubators and accelerators: inbia.org

1 SBA website, accessed March 2016

2 "The Evaluation of the U.S. Small Business Administration's Regional Innovation Cluster Initiative, Year Three Report, Revised November 2014"

3 Before making any investment commitment, an investor must provide a representation that he or she has reviewed the intermediary's educational materials and understands that:

- ***The investment is illiquid***
- ***There is no guarantee of any return***
- ***The entire amount of his or her investment may be lost***

An investor must also attest that he/she is in a financial condition to bear the loss of the investment and has completed a questionnaire demonstrating an understanding of the risks of any potential investment and other required statutory elements.

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CAPITAL MANAGEMENT

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How is GDP calculated in the U.S.?

GDP, or gross domestic product, is a measurement of the total value of all goods and services produced in the United States over a given time period. It is used by economists, government officials, market forecasters and others to gauge the overall health of the U.S. economy.

Although there are several ways of calculating GDP, the *expenditures approach* is the most common. It focuses on final goods and services purchased by four groups: consumers, businesses, governments (federal, state, and local), and foreign users.

The calculation and a description of its components follow:

C+I+G+(X-M)

Consumption (C): Also known as personal consumption, this category measures how much all individual consumers spend in the U.S.

Investment (I): Not to be confused with investments in the stock and bond markets, this is the amount businesses spend on fixed assets (e.g., machines and equipment) and inventories, as well as the amount spent on residential construction.

Government (G): This category tracks the amount the government spends on everything from bridges and highways to military equipment and office supplies. It does not include "transfer payments"--for example, Social Security and other benefit payments.

Exports (X): This is the value of goods and services produced in the U.S. and purchased in foreign countries.

Imports (M): This is the value of goods and services produced in foreign countries and purchased in the U.S.

Historically, the U.S. has run a "trade deficit," which means imports have outpaced exports.

Once the final GDP values are calculated, the percentage change is calculated from one time frame to the next, generally quarter to quarter or annually. Reported quarterly by the Bureau of Economic Analysis, these percentages can influence both investment markets and policy decisions.

What is the most important component of GDP in the United States?

We often hear in the media that consumer spending is crucial to the overall health of the U.S. economy, but exactly *how* important is it? Representing approximately two-thirds of overall GDP, consumption--the almighty consumer--is the largest driver of economic growth in the United States. Of the nearly $18 trillion in U.S. GDP (2015), American shoppers are responsible for a piece of the pie worth about $12 trillion.

Consumption is tracked by the Bureau of Economic Analysis, and is reported as Personal Consumption Expenditures (PCE) in its monthly "Personal Income and Outlays" news release. Since the late 1960s, PCE as a percentage of overall GDP has crept up from a low of approximately 58% to nearly 70% today.

PCE is divided into goods and services. The services category typically represents the largest part of PCE, accounting for more than 65% over the past two years. Examples of services include health care, utilities, recreation, and financial services.

Goods are broken down further into durable and nondurable goods. Durable goods are those that have an average life of at least three years. Examples include cars, appliances and furniture. Nondurable goods are those with an average life span of less than three years and include such items as clothing, food, and gasoline.

Durable goods represent approximately 10% of total PCE, while nondurable goods make up about 20%.

So the next time you're out shopping, for anything from a bottle of ketchup to a new car, consider that you're doing your part to fuel our nation's growth.

Sources: World Bank.org, accessed June 2016; Federal Reserve Bank of St. Louis, 2016; Bureau of Economic Analysis, 2016